

APPENDIX

Notes for FOMC Meeting
May 15, 1990
Sam Y. Cross

In the six week since you last met, sentiment toward the dollar has become distinctly less positive. Three things have occurred. First, the mark's rise, which had paused in February with the uncertainty about German monetary union, has resumed. Second, the selling pressures against the yen have abated, and the psychology appears to be changing. Third, and perhaps most importantly, recent reports suggesting a less robust U.S. economy, together with news of a major effort to cut the U.S. budget deficit, have changed market expectations that dollar interest rates would rise at least as much, if not more than, interest rates abroad.

Reflecting the lessening of downward pressures against the yen, the Desk intervened on only two occasions, in late March and early April. Both times the Japanese authorities strongly urged us to operate and both times the market was questioning whether the U.S. authorities were supporting Japan's efforts to resist the yen's decline. The Desk sold a total of \$100 million against yen in these two operations, of which \$50 million was on behalf of the Federal Reserve. I should note that there were no big differences with the Treasury about intervention operations during this period.

Especially in the early part of the period, the dollar's movements continued to reflect developments overseas. Against the mark, the dollar was strongly influenced by shifts in sentiment about inflationary implications of the proposed German monetary union. As you may remember, before the last FOMC meeting the dollar rose against the mark to a high of over DM 1.72, as market participants became

nervous over the speed at which plans for economic union were being laid. At that time, the feeling in the markets was that, with politicians moving so quickly to reach a currency conversion agreement favorable to East Germany, the Bundesbank might be unable to counter the effects of an inflationary surge in the money supply.

Several things worked to calm those fears, however, and the dollar moved back down against the mark. First, in early March, the Bundesbank demonstrated its readiness to intervene forcefully to maintain the mark's strength. Market participants did not quickly forget that message and, perhaps reflecting this, rumors of Bundesbank intervention emerged from time to time throughout March whenever the mark began to decline. Second, the Bundesbank launched a strong verbal campaign to convince the market that it remained firmly in charge of monetary policy and would take seriously its obligation to maintain price stability, whatever the political leaders decided with respect to a monetary union. The Bundesbank also stressed repeatedly that the market was overestimating the inflationary effects of a monetary union and that the longer-term implications for inflation and for interest rates were much more complex than observers recognized. Thus, by the time the Kohl government announced its detailed proposals for currency conversion, most market participants had moved beyond fears of a near-term surge in inflation and were focusing more on the near-term attraction of higher interest rates and long-term positive effects of stronger growth. In that environment, the dollar moved down to, and then in recent days below, its post-Berlin Wall lows against the mark.

Sentiment toward the yen also improved significantly during this period, though at the time of your last meeting there was little evidence that such a shift in sentiment was in the making. In late March and early April, the yen appeared stuck in a "Catch 22" situation. On the one hand, monetary tightening was deemed necessary to support the currency. But on the other, the domestic stock and bond markets were so vulnerable that any sign of higher interest rates threatened to send domestic markets reeling and further erode investor confidence in yen assets. After the April 7 G-7 meeting, the statement that was issued said that the G-7 had "discussed...the decline of the yen, and its undesirable consequences for the global adjustment process, and agreed to keep these developments under review." But that statement, and the nature of the operations that followed, did little, at least initially, to convince market participants that the others in the G-7 were committed to supporting the yen.

Later on, however, several factors helped to turn the situation around with respect to the yen. First, Japan's domestic financial markets appeared to stabilize in early April. It is still unclear what role the passing of fiscal year-end factors might have played in helping stabilize the Japanese bond and stock markets, but nevertheless it seems that around this time the Japanese authorities also altered their strategy for dealing with the vicious cycle of a weak yen and fragile domestic asset markets. Previously, the strategy seemed to be to support the yen by tightening monetary policy, in the hope that the firmer yen would lend stability to the domestic

financial markets. That was apparently the thinking that led to the Bank of Japan's discount rate hike on March 20. The current strategy, in contrast, appears to focus on first calming domestic bond and stock markets by signaling steady monetary policy, with the hope that a more stable domestic environment will lend support to the yen. And, very importantly, according to numerous market reports the Japanese authorities backed up the effort to reduce downward pressures on the yen with strong "moral suasion" to discourage Japanese institutional investors from continuing to make large, unhedged investments in U.S. securities. So far, this strategy appears to have been relatively successful.

Meanwhile, the political scene in Japan seems to have calmed, particularly following what in retrospect appeared to be a smooth resolution of U.S.-Japan SII talks in early April. More and more, market participants are now betting that Prime Minister Kaifu will last out his term and we hear much less talk of a political vacuum at the center of the Japanese leadership. Given the fact that many large Japanese institutional investors had greatly reduced their hedging of dollar-denominated assets, it is not surprising to hear market participants assert that, from here, shifts in hedging can only operate in one direction--that is, to weaken the dollar vis-a-vis the yen.

At the same time that these various foreign events were unfolding, developments in the United States reversed what seemed to have become a fairly widely held view that the Fed would soon tighten. Until the release of U.S. employment data for April a week and a half

ago, expectations were that U.S. interest rates would keep pace with increases abroad, and that helped support the dollar. Following the employment report, however, a less positive view of the U.S. economy began to take root. Subsequent reports of a new sense of urgency surrounding efforts to reduce the budget deficit--which included mention of a possible securities transfer tax--as well as last Friday's PPI and retail sales data, served to confirm the view that the U.S. economy was weaker than had been believed and virtually eliminated market expectations of an interest rate hike in the United States.

Accordingly, in the last several days market sentiment toward the dollar seems to have undergone an important shift. Whereas in past months, the market's focus had most often been on contrasting developments in Germany and Japan, with the United States somewhat on the sidelines, attention is now shifting toward what they see as a weaker dollar. This comes at a time when the dollar has already declined about 20 percent from its 1989 highs against the mark, and is now trading only about 5 percent over its all-time low of DM 1.56 reached in January 1988. And while the dollar's relatively strong showing against the yen in recent months has at times provided the appearance of a firm dollar, a look at the dollar's performance on a trade-weighted basis suggests how misleading this can be--on a trade-weighted basis, the dollar is down over 14 percent from its 1989 highs.

In addition, I would like to report to the Committee that on March 28 the Mexican authorities drew \$1.3 billion under a facility established just prior to your last meeting, of which \$700 million was

drawn under a reciprocal swap arrangement with the Federal Reserve. The other \$600 million was drawn from a special swap arrangement with the Treasury through the ESF. Subsequently, the Mexicans made partial repayment on two occasions, reducing its outstanding commitment with the Federal Reserve to \$541.8 million by April 27. Mexico's commitment to the ESF was likewise reduced to \$464.4 million. In a separate transaction, on March 30 the Venezuelan authorities drew \$25 million from the ESF as part of a multilateral financing facility. The full amount was repaid by April 30.

One other point. Treasury, at least at lower levels, is considering whether to sell a moderate portion of their DM balances that we hold under warehousing. The idea would be to gradually feed out modest amounts of these DM to the market from day-to-day when conditions are such that they could be readily absorbed without disturbing things. We were asked whether we thought market conditions were such that we could carry out such sales, and we said we thought they were, particularly given the present bearish tone of the dollar. Such sales would reduce somewhat the warehoused balances which now stand at \$9 billion and would provide a bit more headroom on the currency collateral. Other countries, in particular Germany, have for many years followed a practice of discreetly selling from their dollar holdings from time to time. Let me stress that at this point it is just an idea and we don't know whether it will be proposed or not.

Mr. Chairman, I would like to ask the Committee's approval for the foreign exchange operations that occurred during the inter-meeting period. The Federal Reserve share of the Desk's operations represents \$50 million sold against Japanese yen.

FOMC NOTES
PETER D. STERNLIGHT
MAY 15, 1990

Domestic Desk operations since the last meeting of the Committee have sought to hold reserve conditions steady at the degree of pressure maintained through earlier months of the year. The borrowing allowance was boosted for technical reasons by a total of \$150 million to a level of \$300 million, to keep pace with typical spring-time increases in seasonal borrowing as the period progressed. Throughout, it was expected that Federal funds would trade in the neighborhood of 8 1/4 percent, as they have essentially since mid-December.

Funds rates averaged a shade over 8 1/4 percent in the earlier part of the period, partly reflecting some quarter end pressures. Since mid-April, funds were more often than not a shade below the anticipated central point as day-to-day reserve supplies tended to exceed expectations primarily because of lower-than-expected Treasury balances at the Fed. In turn these shortfalls mainly reflected lower-than-anticipated tax receipts, especially from individuals.

Actual borrowing tended to run close to, or a shade above targeted path levels. In part, the heavier-than-path borrowing reflected increased seasonal borrowing, although there were also some bulges in adjustment credit at times. After the path level of borrowing was boosted to allow for the greater seasonal borrowing, total seasonal and adjustment borrowing came closer to path. Excess

reserves alternately exceeded and fell short of the formal path level which remained at \$950 million through the interval.

The shortfall of Treasury tax receipts from earlier expectations made a big difference in the scale of Desk operations to meet reserve needs. With Treasury balances in late April and early May some \$10 billion below the levels anticipated at the time of the last meeting, it turned out that we did not need the expanded leeway provided by the Committee for the intermeeting interval. Outright purchases came to a bit under \$6 billion, mainly comprised of a \$4.4 billion purchase of bills in the market on April 4, and scattered purchases of bills and notes from foreign accounts that totaled nearly \$1.6 billion. Outright purchases were supplemented by repurchase agreements for about the first half of the period. Then, from April 20 through May 11, with the money market comfortable, the Desk took no market action at all to affect reserves--in contrast to the typical heavy provision of reserves in the comparable days of other recent years. Yesterday and today, with a firmer money market, the Desk returned to the market to arrange repurchase agreements to meet estimated needs in the current maintenance period.

Interest rates responded to significant shifts in market sentiment during the intermeeting period--first moving up amid worries about inflation, anticipations of Fed tightening and concerns about heavier debt supplies, and then dropping off in the wake of softer employment, sales and price numbers. At the time of the late March Committee meeting, the predominant feeling was that

policy was "on hold" against the background of a sluggish but still slightly advancing economy and an inflation picture that had seen a temporary bulge likely to be ameliorated soon. Yields on intermediate and longer term Treasury issues were generally within a few basis points of 8 1/2 percent, a level to which they had risen earlier in the year after anticipations of further economic weakening and policy easing steps were largely washed out. During April, the atmosphere grew increasingly dreary. The employment report for March showed only a slight rise in payrolls but this was shrugged off as much to be expected after the very strong and recognizably distorted reports for January and February. Instead there was concern about the slight dip in the March unemployment rate and pickup in employment cost measures. A more severe blow to sentiment was the CPI reported for March with its 0.7 percent rise exclusive of food and energy. Stronger-than-expected data on industrial production and new orders added to concerns. Meantime, the market was besieged by reports of Japanese selling of Treasury securities, and by worries about the rising Federal deficit, particularly exacerbated by thrift bail-out costs. A 40-year Refcorp issue was given a poor market reception even though trimmed in size to \$3 1/2 billion after the poor reception for a \$5 billion issue three months earlier. First quarter GNP deflator numbers added to the sense of distress as did the stronger purchasing managers' report at the start of May. With the Treasury's large mid-May financing coming up, and a serious question raised about the extent of Japanese interest, the market atmosphere had become very

gloomy indeed. A widespread sentiment had developed that the Fed might well move to the firming side, perhaps quite soon. Against this background, intermediate and long term Treasury yields backed up sharply, to the area of 9 percent or somewhat higher.

The atmosphere changed abruptly on May 4, with the publication of weak employment numbers for April, including a 0.2 percent rise in the unemployment rate. Thoughts of imminent tightening were largely set aside. Market rates came down by a quick 15 to 25 basis points--and might well have dropped even more but for the fast approaching Treasury quarterly financing auctions which had already been announced as a record \$30.5 billion of 3-, 10- and 30-year issues. By this time, too, concerns about foreign selling and worries about foreign rate increases had abated. Soundings suggested that Japanese interest in the refunding would be in the normal range, while good noncompetitive demand was expected at least for the 3-year note following the publicity given to the higher rate levels. The auctions on May 8, 9 and 10 were well bid, especially the 3-year note with its record \$ 2 1/2 billion award on a noncompetitive basis largely to individuals. The respective auction yields were 8.74, 8.88 and 8.84 percent for the 3, 10 and 30-year maturities. The day after the auctions were completed the market was further encouraged by reported dips in April producer prices and retail sales (though the April price report ex food and energy was not far from expectations). The combination of receiving these numbers and having completed the bidding on the Treasury auctions spurred a sharp rally that brought Treasury coupon yields

down another 15 to 20 basis points, placing the new issues at handsome premiums to the auction averages. Adding a bit to the improved sentiment were the start of discussions on budget deficit reductions between the Administration and Congressional leaders, and the reports of concerns among banking regulators of a possibly excessive squeeze on credit availability growing out of credit quality reviews.

On balance over the intermeeting interval, Treasury coupon issues maturing out to about 3 years showed small mixed changes in yield, while yields on longer issues were up on net by some 10 to 15 basis points. The new 30-year bond closed yesterday with a yield around 8.60 percent. The Treasury raised a net of about \$20 billion in the coupon market, including about \$13 1/2 billion in the quarterly refunding that settles today. Current market sentiment seems to envisage little likelihood of a significant rate move, or policy move, in either direction in nearby months. Looking further out one can find some market anticipations of both higher and lower rates--but after the recent swings in sentiment the views don't seem to be held with great conviction. It's particularly hard to gauge the current impact of budget deficit negotiations; mainly, the market remains quite skeptical, though there is a glimmer of hope that something meaningful could materialize. Certainly there is a sense that a credible deficit reduction move, if it came, would have a significant rate effect. But we also hear of some concern that the Administration or some in Congress might seek to use the mere

fact of budget discussions as a way to push the central bank into responding prematurely.

Treasury bills also showed an up and then down move in rates during the period as sentiment worsened and then improved. The rate rise during April was somewhat dampened by the Treasury's heavy paydown of cash management bills after the April 15 tax date. Net over the period, shorter bills--out to around six months--declined by some 20 to 25 basis points, while year bills were down a more modest 10 basis points or so. The Treasury paid down a net of about \$15 billion in the bill market, with cash management bill net redemptions of about \$25 billion partly offset by regular cycle increases of roughly \$10 billion. In yesterday's auctions the 3- and 6-month issues went at average rates of 7.67 and 7.68 percent, respectively, compared with 7.85 and 7.83 percent just before the last meeting.

For the most part, rates on private instruments moved roughly in line with those on Treasury paper, but one noteworthy exception was bank holding company paper, for which spreads over Treasury yields tended to widen appreciably. A number of large banks and holding companies were downgraded or put on watch-lists for possible downgrading by rating agencies, and investors were wary of these and other issues that they thought might become less liquid. There was also some skittishness reported among investors in commercial paper, especially on the part of money funds whose managers are understandably nervous about the possible reaction of fund investors to any threat of defaults.

On a housekeeping note, I should mention that the Desk recently established trading relationships with three firms that had been added previously to the primary dealer list--Dillon Read, Barclays de Zoete Wedd, and UBS Securities. At the same time there are rumblings that some other primary dealer firms, discouraged with their poor profitability record, may withdraw from active market making or perhaps seek to sell their operations which under our guidelines would entail at least temporary de-listing as a primary dealer.

Michael J. Prell
May 15, 1990

FOMC BRIEFING -- ECONOMIC OUTLOOK

As I hope we made clear in the Greenbook, this month's forecasting exercise had two distinct components. The first was the usual attempt to divine the basic tendencies in the economy in light of incoming information. The second was the adjustment we made with respect to the assumed objective of policy, based on what we heard at the March meeting.

Turning to the first part of the story, the news since the last meeting is, as usual, subject to varying interpretations. Our own is that the economy probably is now expanding at something like a 2 percent annual rate, with activity likely tending to pick up over time rather than to weaken. To reach that conclusion, I think it would be fair to say that we had to do a lot of reading between the lines of the recent monthly data.

The April labor market report, for example, showed an absolute decline in private payrolls and a 2/10 uptick in the jobless rate. However, much of the weakness in employment was accounted for by construction, where favorable weather previously had pushed activity, on a seasonally adjusted basis, well above sustainable levels. And, though there was softness in some other industries, too, the figures generally appeared consistent with our prior view that the employment increases earlier in the year were vastly overstating the underlying thrust of the economy. As for the increase in the unemployment rate, it seemed to us

long overdue, given the reported pace of economic expansion and the rise that had occurred in 1989 in the number of recipients of unemployment compensation. All things considered, we think it reasonable to anticipate a small increase in hours worked this quarter, along with a bounceback in nonfarm productivity after the first-quarter drop.

On the spending side, Friday's advance reading on April retail sales also was far from robust. These data are volatile and subject to sizable revision, so at this juncture we're inclined to say only that they suggest a possibly slow start on what we already were anticipating to be a rather subdued quarter of consumer spending on goods ex. motor vehicles. Our expectation is that the momentum for overall consumer spending will continue to be mainly from the service side.

Returning to motor vehicles, however, sales have been steady, if unspectacular, and the manufacturers should be able to hold close to their scheduled May and June rates without reversing the sharp inventory cuts they achieved in the first quarter. As you know, we estimate that the step-up in motor vehicle assemblies should contribute better than a percentage point to real GNP growth this quarter.

Stronger auto output also should bring about a rebound in industrial production, after the auto-related drop of 4/10 of a percent in April. Outside of autos, however, the signs for the manufacturing sector are mixed at this point. On the positive side are the March inventory data, which showed less accumulation than the Commerce Department anticipated in its advance estimate of first-quarter GNP. Our recent forecasts had included an adjustment of stocks in the first half of this year; the evidence now suggests that the correction has

progressed faster than we had expected, and this could well clear the way for better manufacturing activity in coming months. Firmer materials prices and the tenor of recent surveys--including those of 1990 capital spending plans--also suggest the possibility of some pickup.

To date, though, a break-out evidently has not occurred, and some of the explanation for that perhaps is to be found in developments in defense, construction, and foreign trade. Military procurement clearly is in a downtrend. Construction put in place fell off sharply in March, and we expect further slippage in home and office building, in particular. This should put a damper on activity in a variety of manufacturing sectors supplying the building industry, and, indeed, production of construction supplies has been off sharply in the past two months. Meanwhile, the net stimulus to manufacturing coming through the external sector appears minimal at this time. Although the merchandise trade deficit did improve considerably in January-February, relative to the fourth-quarter level, there were a number of transitory influences. The quantity of nonagricultural exports was disappointing and, although nonoil imports did fall in the first two months of the year, the special survey recently completed by Reserve Bank staff suggests that competition from imported goods remains intense.

The net of all of these considerations is that we probably are now in a phase of somewhat faster output growth than we saw over the past two quarters, largely because the inventory drag should be behind us. In contrast, the picture for prices currently is one of deceleration after the first-quarter bulge. The April PPI published on

Friday not only showed big drops in food and energy prices, but also an increase of only 0.2 percent for other finished goods. This basically confirmed our expectations, and it does not alter our perception of the underlying trends. Taking account as well of the incoming information on labor and other costs, it still appears that, at prevailing levels of resource utilization, the trend of inflation is likely to be gradually upward.

It is on that point that I perhaps should turn to the other major theme I noted at the outset--that is, the adjustment we made to take account of comments at the last meeting that suggested we might not be reflecting in our projection the Committee's concerns about inflation. Attempting to be responsive, we designed this projection with a view toward indicating to you how, through a more aggressive tightening of money market conditions, faster and surer progress might be made toward the restoration of a discernible disinflationary trend. Thus, we now have the funds rate rising about 25 basis points per month, starting soon, and peaking at a little over 10 percent by the first quarter of 1991. This sharper tightening pulls the long Treasury bond yield up to about 9-1/2 percent, and causes the dollar to appreciate slightly.

Under these circumstances, GNP is projected to increase only 1-1/2 percent next year, and the unemployment rate is projected to reach 6-1/4 percent. As a consequence, even though we've raised our forecast of inflation for this year a bit, the greater slowing in activity, coupled with a smaller expected rise in import prices has caused us to project a somewhat lower rate of inflation for 1991 than in the March

Greenbook. Nonetheless, we are still showing the CPI rising at a rate in the vicinity of 4-1/4 in late 1991, and it likely would require the maintenance of the projected degree of slack through 1992 to move the inflation rate below the 4 percent mark, absent favorable supply-side shocks or credibility effects.

I'd like to conclude with a few words about three uncertainties in the economic environment, which are relevant to the question of whether so sharp a policy tightening--or any tightening at all--may be needed to rein in aggregate demand. One of these uncertainties is, of course, fiscal policy. We have adopted a wait-and-see attitude toward the current budget discussions. If a bigger deficit-reduction action than we've assumed is forthcoming, it could significantly alter the outlook, presumably in the direction of less interest rate pressure. It also is probably still too early to gauge with confidence the real effects of the credit crunch phenomenon. We continue to think that something has happened, and it is a significant element in our projection of construction activity, especially, but the non-rate financial restraint we have embedded in this projection falls well short, I think, of what might be the case if credit supplies have constricted as much as some of the horror stories would imply. Finally, a risk running in the opposite direction from the two I've just noted is that the dollar might come under renewed downward pressure, if market participants' concerns about exchange rate relationships are rekindled by a lack of further progress in external adjustment. In short, it looks to me like you as policymakers are going to have to decide how to play your hand with the discomfiting knowledge that there are some real jokers in the current economic deck.

May 15, 1990

FOMC Briefing
Donald L. Kohn

As has been evident in the discussion at this meeting, developments over the intermeeting period--indeed, since year-end--have highlighted two key issues facing monetary policy. One involves inflation--its current strength and prognosis relative to the Committee's objectives. But evaluation of the course of the economy and prices has been complicated by another issue--disturbances to the credit markets and intermediation process.

Available evidence does not now seem to suggest restrictions on credit availability that are having major effects on aggregate economic activity, though certain sections of the country and types of activity are undoubtedly being affected by a reduced willingness or ability to extend credit. Aggregate credit flows to nonfinancial sectors have slowed a little so far this year, but the moderation appears to be mainly in the household sector and reflects diminishing demand rather than tightening supply. Overall credit to nonfinancial businesses appears to be well maintained, outside of lending to finance equity retirements. Moreover, spreads between private market instruments, at least those with investment-grade ratings, and Treasuries, though widening a bit, remain fairly narrow, suggesting the absence of a generalized flight to quality.

Yet there are numerous signs of difficulties in financial markets that potentially could affect the cost and availability of funds over a wider range of borrowers, impinging on spending plans and the ability to

carry them out. Declines in the prices of bank and bank holding company stocks and bonds and tighter funding markets for investment banks raise questions about the capacity of these institutions to exercise their intermediary functions in the same way they have been. Survey results do suggest some tightening of credit standards and increase in nonprice lending terms at banks, not only for real estate and highly-leveraged transactions, but for small and medium-sized business borrowers as well. The reluctance of banks, investment banks, and final investors has curtailed the access of noninvestment grade borrowers to credit. Even for investment grade borrowers, continued narrow yield spreads do not connote unchanged relative borrowing costs, since ratings, on average, are declining.

Unfortunately, much of the information needed to judge whether these developments may be affecting the economy more than anticipated is not readily observable. We do not have comprehensive data on the nonprice terms and conditions of most credit; aggregate credit flows are available with a lag, but large portions of the series we use are based on fragmentary data.

In this partial vacuum, it is tempting to try to read the behavior of the monetary aggregates as indicating something about underlying credit conditions. Shifting credit flows have affected the aggregates, contributing to their sluggish growth in recent months and their shortfall relative to expectations. However, interpretation of whether the recent behavior of the various money measures is signalling credit availability

constraints that could have unexpected consequences for the economy is not straightforward.

For one, the most pronounced slowing of M2 occurred in April--a month in which huge tax payments often add considerable noise to money numbers, well beyond the ability of seasonal factors to smooth.

In addition, a portion of the slowing in M2 reflects a normal response to the rise of intermediate- and longer-term interest rates since yearend. The decrease in M2 growth from this source may be a leading indicator of restraint on demand from the higher interest rates. To be sure, the increase in rates was not directly engineered by the Federal Reserve through tightening reserve conditions. Still, some restraint would be entirely appropriate if, as seems to be the case, the higher rates reflected a more buoyant economy than many had anticipated and greater inflation pressures.

However, growth in the aggregates also has been held down by the unusual weakness in the volume of loans on the books of depository institutions. This effect has restrained M3 for some time as assets and associated funding at thrift institutions have run off. But the effects have spread to M2. Through the first quarter, bank credit, while not decelerating, also did not pick up as thrifts downsized. Then in April, bank credit growth dropped off somewhat. With transfers of retail deposits from thrifts helping to sustain inflows of core deposits, banks have held down offering rates on deposits, raising opportunity costs and boosting contemporaneous M2 velocity.

Even the additional weakness in M2 from this source may not indicate credit market disruptions that ultimately will feed through to the economy. Rather it could represent a permanent shift in velocity. The result depends on the nature of the shortfall in depository intermediation. In many respects, the financial markets are considerably better able to handle "disintermediation" now than in the 1960s and 1970s. The expanding markets for securitized loans enable borrowers and lenders to be brought together using the services of an intermediary--but not necessarily its balance sheet. Thus, when the disruption seemed to be confined to mortgages, with consequences primarily for M3, it could be viewed with some equanimity. If the disruptions were to spread to credits that ordinarily remain on depository balance sheets--or if the problems with the broader intermediary system affected its ability to bring borrower and lender together--then borrowers could face higher effective costs of funds or reduced availability, and their spending might be damped.

Some tightening of credit terms and moderation in lending, which might show through to M2 as well as M3, would be a natural, endogenous response to shifting economic conditions. Slow economic growth implies weakness in certain sectors, and additional care by lenders would be a fundamentally healthy response, if scaled appropriately. The problems would arise from an overreaction by depository institutions and other lenders--whether driven by their own exaggerated response to increased borrower riskiness, or by that of their regulators. A flight to quality could feed back into spending in ways not captured by current projections.

So far, the slowing in money growth would not seem to signal deeper underlying problems in the financial system that would have extraordinary consequences for the economy. This judgment is based on corollary evidence from surveys and the like, recognizes the annual problems of interpreting April money growth, and takes into account that M2, while slowing, remains in the upper half of its annual range. Tighter terms and reduced availability might be reflected in credit flows and spending only with a lag, however, given the momentum of previous lending commitments. The staff is projecting a pickup in M2 over the next few months from the unusually depressed growth of April under all the short-run alternatives in the bluebook. To some extent, this projection is based on the diminishing effects of previous interest rate increases--especially now that rates have retraced some of their earlier rise. But, in addition, it is premised on no intensification of any restriction on credit availability, so that bank credit picks up as well, and banks continue to raise retail deposit rates, albeit slowly. A sustained, substantial, shortfall in M2 over the balance of the quarter might bear close scrutiny. Such a development would not be a definitive signal that underlying problems were deeper than anticipated, but it would be suggestive. In particular, persistent weak money growth accompanied by further sizable declines in interest rates might be cause for concern, since the latter might be a product of weakening economic activity, produced perhaps by reduced credit availability.

The issue of judging and reacting to possible credit disruptions has important implications for considering the other main issue of policy --the outlook for inflation relative to the Federal Reserve's objective, and the balancing of that objective with the avoidance of recession.

One could argue that the developments of 1990 suggested a somewhat narrower path between the FOMC's twin goals of restraining inflation on the one hand and avoiding recession on the other. First, recent data on consumer inflation and labor compensation may indicate that the economy is operating at a level beyond its capacity to produce without accelerating inflation. If this is the case, the economy needs to grow noticeably below the rate of potential real GNP growth for some time, as in the greenbook forecast, leaving less room between this path and recession. In addition, one can not dismiss the possibility that inflation expectations have deteriorated a bit. Despite decreases in many short-term rates, bond yields still are up over the intermeeting period, suggesting that the price and labor cost data may have left their imprint on the longer-run price outlook. If so, the near-term trade-off between inflation and output has become more adverse--that is, it will take a more prolonged or greater softening in economic expansion to counteract these expectations, build credibility, and damp inflation.

In these circumstances, balancing concerns about financial fragility with those about inflation could be especially difficult in coming months and quarters. The room for error is smaller, given the Committee's twin objectives, and the FOMC must judge a credit-availability phenomenon whose strength and effects are difficult to gauge, in part because there

are no recent precedents. From one perspective, if inflation were considered to be a problem, some tightening of nonprice credit terms would be helpful, substituting to an extent for an outright firming of policy. But, of course, a further deterioration of credit conditions leading to a substantial weakening of the economy is also a possibility.

On the other hand, a policy preoccupied with threats to financial markets and avoidance of recession could tend over time to be biased toward ease--a bias that would be all the more likely when the acceptable zone for the economy may have narrowed. The costs of such a bias would be not only escalating inflation pressures, but also reduced Federal Reserve credibility for its price stability objective, raising the costs of ultimately achieving that objective.